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Sound value vs fair market value

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Sound Value vs. Fair Market Value

SOUND value and fair market value frequently are considered to be synonymous. In fact, one author has defined sound value as "the current market value which would induce a willing seller to sell and a willing buyer to buy." This is the generally accepted definition of fair market value. However, there is, in fact, a distinction between sound value and fair market value even though sound value may at times be equivalent to fair market value.

Sound value is the replacement cost of the property, less the accrued depreciation. Replacement cost means the current cost to reproduce new the identical units of property under consideration. This value usually differs from original cost because of fluctuations in the general price level. Depreciation is computed on the basis of the replacement cost. Cost to replace, less the depreciation sustained to date, therefore, gives sound value—the value of the property to the concern using it.

Fair market value takes into consideration all the factors which go to make up sound value, plus some others. It is analogous to exchange value, taking into consideration current market conditions, the present and potential earning power of the property, the condition of the industry for which the property is adapted, and the current supply and demand for properties of like character and condition. In making an appraisal to ascertain the fair market value of property, these factors, therefore, must be investigated in addition to the usual investigations required for the proper determination of sound value.

Fair market value should not be confused with fair value. Fair value is a term used in the valuation of public utility properties for purposes of rate-making. The determination of fair value affects rates and income, and rates and income in turn are a vital factor in the determination of exchange value. Hence, fair value must be determined before exchange value, or fair market value, can be ascertained. Fair value and fair market value, therefore, are not identical.

Sound value may be greater than fair market value, if for some reason or other the property in question is not salable. It may be that the property has a poor earning history, or that there is a lessening demand for the products, or the industry is suffering from over-production, or the industry has been declared an illegal one. Breweries are a case in point. A brewery may have a sound value of $100,000, and still have little or no fair market value because of the lack of demand for structures of this type.

Occasionally fair market value may be equivalent to sound value. If an investigation of all the factors which go to make up fair market value shows that the earnings are, and will continue to be, equal to the average return on property in the industry, then fair market value may be considered to be equivalent to sound value.

It is conceivable that fair market value may exceed sound value. If the factors which go to make up fair market value are exceptionally favorable, it would seem that at any particular time fair market value could exceed sound value. Take, for example, a munitions factory at a time when war is declared. The demand for the product is very great; prospects for exceptional earnings are good. There are not enough munition factories to supply the demand. It takes months to build new factories. It seems perfectly reasonable that a factory already in existence would, under such circumstances, have a fair market value in excess of sound value. However, such a situation would be only temporary, for there would be an inducement to build other factories until fair market value ceased to be greater than the sound value.